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Edward E. Furash

BANKS ARE OBSOLETE—AND WHO CARES

EDWARD E. FURASH[†]

In the emerging global financial structure, the banks that we know and cherish will be obsolete. Other than the armies of bankers, regulators, lawyers, and consultants whose jobs will be at stake—who cares? And why should we? We know that the functions of banking are essential to a modern economy, but if some other entity can bring savers together with borrowers; absorb credit, interest rate, exchange, or maturity transformation risk; provide a reliable payments system; facilitate monetary policy; or provide fiduciary and safekeeping services faster, smarter, or cheaper than banks, then it will replace banks. This is precisely what has been taking place and will continue to take place unless we act to prevent it.

I. WHY WE OUGHT TO CARE

Well, we ought to care, and we ought to do something about it, because banks play a special role in creating prosperity. Until we can be certain that the new financial structure, the new financial processes, and the myriad of new financial players can do as well or better than banks, banking, and bankers have done over the past few thousand years, we should think hard before we toss banks aside. We run an enormous risk by not moving aggressively to transform banks into the new financial institutions that are needed to ensure prosperity tomorrow.

All societies seek economic and social prosperity in some form. We often overlook this fundamental goal when thinking about the structure we need for our financial system. We can become so involved in arcane discussions about deposit insurance, interstate branching, or derivatives safety that we neglect the fundamental purpose of banking—to facilitate trade and to foster investment in order to create prosperity.

[†] Chairman, Furash & Company, Washington, District of Columbia; A.B., 1956, Harvard College; M.B.A., 1958, University of Pennsylvania.

II. THE PURPOSE OF BANKING IS PROSPERITY

The foundation of prosperity is a sound currency and a reliable payments system. Without these, we would have economic anarchy. Investors would see no basis for putting money at risk. Savers would worry about the value of their money and inflation. Goods and services would not change hands, because payment would not be certain. The result of this economic anarchy would be poverty, not prosperity. The purpose of banking is to provide a stable world in which commerce can flourish. In a simple economy, the chieftain need only ensure that barter does not lead to violence and that everyone understands the worth of a cocoa bean or a cowrie shell. In a complex economy, such as ours, many devices are needed to create and ensure stability. These are the functions of banking. Those of you who have traveled to Eastern Europe or Russia know how the lack of simple monetary and banking devices impedes the economic stability that is necessary to lead to prosperity. The post-war German and Japanese economic miracles came about through banking and through the governmental efforts to ensure a sound currency and a reliable payments system, thereby providing the stability needed to facilitate trade and foster investment.

Stability is significantly undermined when banking functions are performed by multiple, uncoordinated financial entities. During the past twenty years our financial system has fragmented significantly, with many new financial entities picking off banking functions, because they were less regulated or unregulated, more efficient, more aggressive, or quicker to see an opportunity than banks. All to the good, most would say, and a true demonstration of how a free market economy works and overcomes barriers. But none of this could have happened if banks were not at the core of financial activities—ensuring sound currency and a reliable payments system. Banks have provided the stability and framework that, in essence, handed nonbanks the tools necessary to pick away at banking activities.

The truth is, as banks become increasingly less relevant, something must replace them in providing the coordinating and stabilizing functions required in a free market economy. At this point, no such institutional structure has emerged, despite all of the proposals circulating in Congress. This is why we should care about strengthening banking.

III. THINGS DON'T WORK THE WAY THEY SHOULD

Many of us will try to measure the decline of banking in terms of market share, value-added contribution, or by adding back off-balance sheet activities so as to reflect the continued importance of banking. All of this is interesting, but it is not particularly relevant. Even if we produce measures that show that banking has not lost its share of financial activity, we cannot ignore the evidence from the financial marketplace of what is really happening. Traditional banks have lost their economic influence.

We know by observation alone that the banking system doesn't work the way it used to—if it does at all—in fostering prosperity. Money supply data no longer provides an accurate measure of economic activity or serves as an instrument for monetary policy. Policy makers have had to shift their focus to interest rates and commodity prices instead. The fact that this shift has been somewhat successful does not replace the need for a banking system that works.

Look at the difficulty that we are having in controlling the slide of the dollar. And think about the near hysteria over the risks in derivatives. The game and guidelines are the same, but actions do not produce the results that they did in the past. To borrow from Gilbert and Sullivan, we are playing economic billiards with elliptical balls and warped cues.

At best, we are muddling through; at worst, we have lost the handle on the way to create economic well-being. One hallmark of civilization—and certainly of our nation—is to ensure prosperity for us and our posterity. That is why we should care about banks.

IV. ARE BANKS STILL SPECIAL?

In 1982, Gerald Corrigan, then president of the Federal Reserve Bank of Minneapolis, presented a noteworthy case that banks were special because they provided three crucial economic functions: (1) *payments and store of value*—banks issue transaction accounts, for instance, they hold liabilities payable on demand at par and that are readily transferable to third parties; (2) *stability*—banks serve as the back-up source of liquidity for all other institutions, financial and nonfinancial; and (3) *sound currency*—banks are the transmission belt for monetary policy.

And in fifteen short years, the influence of banking on these activities eroded significantly, weakening our ability to ensure the sound currency and reliable payments system needed to create the stability required to facilitate trade and foster investment.

For example, while banks still dominate the traditional payments system directed at transfer of monetary value, our recent study on the Future of the Payments System for The Bankers Roundtable concluded that users—consumers, businesses, and governments—neither care nor take for granted the risk absorption, settlement finality, and liquidity that banks provide. They see these payments system elements as entitlements for which they need not pay; therefore, they are turning to nonbanks that provide the value-added payments information they seek and for which they will pay. Traditional monetary transfer is now a commodity, and nonbankers ride on this transmission system by providing added value payments services.

They could not do this, of course, if our banks and the Federal Reserve had not created one of the world's best payment systems. But these nonbank activities have pulled revenue away from banks, weakening their profitability and their role in financial services. Similarly, consumers can get virtual transaction accounts from insurance companies, finance companies, brokerage firms, and mutual funds. Moreover, bank deposits clearly are not seen as a superior store of value over money market mutual funds by large segments of the public. In sum, banks are no longer special in the payments system or in providing a reliable store of value.

By and large, banks still are an important source of liquidity to other institutions. In this sense, they still must be relied on to provide stability as they did for the mutual fund and securities industry in the stock market crash of 1987. But they are not the special source of stability. Other institutions now have direct access to the Federal Reserve window. Government Sponsored Enterprises (GSEs)—such as Fannie Mae, Freddie Mac, or Sallie Mae—now provide stability to the mortgage and student loan markets. And Congress and the Clinton Administration have talked seriously about extending the GSE model to small business financing. Much more could be said about securitization or direct market financing to further prove the point that banks are not as special as they once were in providing stability through back-up liquidity.

One only needs to look at the events of the past three years to see deterioration in the role of banking as the transmission belt of monetary policy. Capital markets, pension funds, and mutual funds probably play a greater role than banks in the bond markets. Synthetic securities with unknown market characteristics are manufactured mainly by nonbanks. With the volume of direct placement and junk bonds expanding, banks are no longer the prime money source for high-quality borrowers. When demand is weak, as it was during the recent recessions, low rate business loans generally do not lead the recovery. What led the way was a complex amalgam of mortgage refinancing supported by the secondary market; cheap consumer loans through securitization; and massive corporate refinancing in the equities market. Pricing in financial services is now set by the securities market, not banks. Securitization puts a ceiling on consumer loan rates. Money market funds set the floor for deposit/funding rates.

Sound currency is more difficult to maintain in this new fragmented world. In other words, the new financial structure is undermining, not enhancing, our economic well-being. So, we should care about banks and what may replace them.

V. WHY ARE BANKS BECOMING OBSOLETE?

Why are banks becoming obsolete? Obviously, because they have not been able to adapt to the new financial world. The regulatory structure and financial services separations of the 1930s—Glass-Steagall, deposit insurance—do not fit today's world. Even the Bank Holding Company Act is antiquated. Banks still cannot engage in many activities commonly included as banking in other parts of the world. The gradual widening of powers in the past few years has helped, but not enough. Banks now perform only twenty-five percent of financial activities, down from fifty percent to sixty percent at the end of World War II. While it is easy to blame banking's straight jacket on past legislative and regulatory follies, they are only part of the current problem. The need for change is widely recognized, and one can only applaud the actions of the Federal Reserve and the Office of the Comptroller of the Currency to widen banking powers, particularly in the field of securities; however, but the emphasis on banking reform is insufficient: what the country needs is total financial services reform.

Three quite disparate forces have combined to put banks in a box: fragmentation of the intermediation process; technology that facilitates the change that undermines traditional banking; and marked changes in customer preferences.

VI. INTERMEDIATION

The intermediation process has shifted away from institutions that take principal risk by taking loans and investments on their balance sheets and, in so doing, risk shareholder capital, toward placement facilitators who manage funds for others, but take little or no capital risk. Commercial banks, life insurance companies, thrifts, credit unions, broker/dealers, finance companies, and mortgage banks still are wholly or partially traditional, complete intermediators. Retail mutual funds, trust funds, investment managers, stockbrokers, GSEs, REITs, and financial guaranty companies are facilitators that manage the money of others. Their funds-gathering and investment management process is significantly more efficient than traditional intermediators. Their growth has been facilitated by securitization, synthetic securities, junk bonds, and direct market debt placement by corporations.

The net effect is that the quality of credits available to banks has declined, the volume of loans available has declined, and net interest margins will probably also decline. Dollar volume from intermediation is not able to support bank cost structures. When banks have reached for risk to restore intermediation earnings, it has been costly—as witnessed by the $500 billion taxpayer cost for the bailout of the thrift industry or the numerous commercial bank failures of the past decade. Compared to the past and relative to current competitors, banks are weaker players in the intermediation process, and (1) they are less able to act as the transmission belt of monetary policy; (2) they play a smaller role in facilitating trade; and (3) they are less significant in the process of ensuring stability and prosperity. Yet no central market mechanism has emerged to replace them in their role, and one wonders how much less of a role banks can play before our financial markets become unstable. As noted earlier, the securities market now sets both sides of intermediation pricing. But this invisible hand is not sufficient to replace banking's traditional role in fostering prosperity.

VII. TECHNOLOGY

Technology has been the great facilitator of banking's decline. While it has enabled banks to become more efficient and to achieve economies of scale in operations, it has also brought into the market severe nonbank competition in, for example, credit cards and mortgage banking.

We could not have the securitization or synthetic securities that have raped bank balance sheets without the computers that make them possible. Nor could nonbanks have created complementary payments systems without technology access to the bank payments system and the ability to simulate bank products. Technology has enabled nonbanks to create the information-based investment management, programmed trading, and comprehensive customer statements that provide them with a considerable edge over banks.

In the past, banks have been able to adapt to technology change. Banking is an information business. In banking—in all financial services—knowledge is power. And payments systems rely on transferring information, whether a letter of credit on a Medici bank or a wire transfer tomorrow.

Banks have been able to adjust to signal fires and semaphores, messengers and carrier pigeons, sailing ships and steam ships, telegraph and telephone. But they have not been able to adapt to the new competitors created by making information ubiquitously available through computers and modern telecommunications. Computers create new financial markets by enabling information to be gathered and widely disseminated by telecommunications. Nonbank competitors can create place-and-time advantages over banks. In sum, the computer and modern telecommunications have enabled nonbanks to simulate banking services and functions in ways that customers cannot distinguish, and even prefer.

VIII. CUSTOMER PREFERENCES

Customers have tried these new financial services and like the heady wine of money funds, draft accounts, cash management, and electronic data interchange. They have and will continue to shift from a savings mentality, which favors bank guaranteed deposit returns, to an investor mentality, which favors using facilitators to produce riskier but superior market returns.

Our nation is going through a deep cultural change from saver consumers whose attitudes were formed by the Great Depression and World War II, to investor consumers whose attitudes were forged by the rebellion of the 1960s and the Great Inflation that followed in the 1970s. Corporations seek radically new financial services, like information-based inventory and cash management. They also seek to hedge against rate and market risks. Nonbanks have become the preferred providers of these activities. While banks have an enviable customer base and the game is theirs to lose, lose it they will if restricted by regulation or legislation. Currently, the banks are playing catch-up. And in the customer's eyes, banks are less competitive and less important to them than in the past.

IX. CAN BANKS BE REPLACED?

With all of this, financial services in general, and banking in particular, have become a much riskier business in every way. The thrift and bank failures of the past decade have prompted a regressive attitude by Congress. No legislator wanted to go home and tell voters that the cost of maintaining economic stability was by underwriting the deposit insurance funds. In the attempt to make banking accident-proof and risk-proof, government has fostered regulations that micromanage the industry and that weaken the role of banking in facilitating trade and encouraging investment—our real goal of creating prosperity. In sum, a new financial structure is emerging in which traditional banks are becoming obsolete, and they are being replaced by new entities and processes.

This is a paradox—since none of these things could happen if banks were not strong and had not been providers of liquidity and a reliable payments system. But as banking's role declines, no institution or structure is emerging to orchestrate and coordinate our economic well-being. And if banks disappear, we will have to invent something else to take their place as stabilizers.

The solution is not to spread banking functions among multiple uncoordinated entities. The solution is to strengthen banks so as to create even greater free market competition in financial services. Banks will then be strong enough to continue to fulfill their core purpose of fostering a sound currency and a reliable payments system. Strong banks with broad powers establish the financial core that supports diverse financial specialists. Weak banks will cause financial specialists to contract, because weak banks cannot provide the liquidity that financial specialists require. In that event, it seems likely that the economy will be worse, not better—despite the belief that nonbank financial companies will proliferate to take up the vacuum. These emerging entities are neither strong enough nor comprehensive enough to pick up banking's economic role.

The core problem in keeping banks strong is the fragmentation of the intermediation process. Prior to the Civil War, our banking system was based primarily on the issuance of redeemable bank notes. Since then, banking has turned increasingly into a direct intermediation business, taking deposits and making loans. Spread income, as we all know, is still the primary source of bank earnings. But deposits have moved out of banks to facilitator investment managers, and fewer loans are available at higher risk, severely weakening bank profitability. This bank earnings model outlived its usefulness twenty years ago, but restrictions on banking activities prevented both loan risk diversification and new sources of income from coming to the rescue. The troubles that followed are well known. While banks were weakened, nonbanks quickly dominated the new securities industry, the new finance industry, the new processing businesses, and the hot new field of investment management.

X. WHAT TO DO

What needs to occur to strengthen banks is so simple that we easily lose sight of it. Therefore, it needs repeating—lessen dependence on dying intermediation businesses; increase capital markets activities, including such frightening activities as investment banking, trading, and investments in derivatives (the forbidden "D" word); and increase fee-based businesses, particularly payments systems, investment management, and servicing businesses such as mortgage banking. These strategies, along with cost-cutting, consolidation and mergers, interstate branching, service quality, and stringent risk management are the "rosary beads" of bank management today.

Rebalancing these income streams will be no simple task. First, there is new formidable nonbank competition in all of these businesses. Second, replacing loan intermediation with trading or derivatives requires new risk management skills that most banks do not have. Third, the volume of fee income as a facilitator, processor, or investment manager needed to replace lost spread revenue is very large. Except for a few banks, it may not be possible. All of this rebalancing must come with safety and soundness—by management prudence and regulation that supports, not impedes the restructuring process. The result will be a radically different banking industry with fewer players that will individually be stronger in terms of their ability to influence the economy and foster prosperity. But despite their size, these banks will still be small players in the financial services industry.

Current bank strategies are not sufficient to enable banks to become the broad gauge financial companies our country needs. A far better solution is to let banks out of their box and to encourage the melding together of all financial services companies, enabling the free market to create the new financial services industry needed to ensure stability and a sound currency. In effect, recognize that the future requires financial service companies that happen to carry out banking functions, and allow this evolution occur. Otherwise, instability will result. We are perilously close, in my view, to what

Robert Eisenbeis, a former professor of the University of North Carolina, called an electronic barter world.

The history of money and banking is a tale about the role of government in creating or destroying prosperity over the past few thousand years. The U.S. Constitution states that a purpose of government is to establish a sound currency. In addition, we, as a nation, are committed to fostering prosperity. We are already the economic miracle that the world envies. Frankly, our banking system played a major role, if not the major role, in creating our prosperity. For the past sixty years, our governmental philosophy was that this was best done by restricting banks and by holding banks hostage through regulation geared to deposit insurance. In the process, banking has become quasi-nationalized and is unable to fill its proper economic role.

In the long sweep of monetary history, these past sixty years are an aberration. It is time to recognize that we cannot succeed by micromanaging banks or other financial service providers. The task is too complex and, frankly, it is falling of its own weight. It is time to recognize that this philosophy no longer applies and must be repealed.

There are four major steps that must be taken. First, as noted earlier, we need to recognize that financial services reform and restructuring is the key issue, not banking reform. We must charter new, broad gauge financial companies that become the transmission belts of monetary policy, ensure a reliable payments system and sound currency, and have the true strength to provide back-up liquidity. Second, we must have a radical revision—even sharp reduction—of the regulatory structure and combine financial regulation to suit the new structure, concurrently eliminating the Congressional turfdoms that prevent reform. Third, we must remove the millstone of federal deposit insurance by making it available only to small balance consumers and businesses and letting capital ratings and private insurance take up the slack. Fourth, we must stop bleeding financial services companies for social engineering purposes. There are other, more direct means to achieve social justice that do not distort our financial system.

If banks did not exist, we would have to invent something new to ensure the sound currency and reliable payments system needed for tomorrow's stability and prosperity. That is why we must care about banks. It is time to turn back the clock, to recognize that our sixty-year experiment must end. We need a new system—a strong central bank, the creative tension of dual regulation and chartering, and financial companies that can engage in all financial service activities in a free market world.

Bluntly, we need to throw out the financial system and start over. Sadly, there is little or no stomach for such radical changes among the members of the U.S. Congress. Special interest groups are able to hold reform efforts hostage in order to obtain special advantages. Frankly, with their livelihoods at stake, who can blame them? This is, however, short-term thinking. In the long term, the resistance to reform will weaken our ability to ensure prosperity by growing the economy.

For the heart of the issue of banking reform is ensuring economic growth. Americans are becoming increasingly discouraged by the decline in their purchasing power—they work harder and harder and receive less and less. Lack of economic growth is a key reason that Americans believe the American dream is no longer being realized.

The changes needed—a major overhaul of the tax system, the downsizing of government, and the encouragement of high savings and lower debt—are wholly intertwined with a renaissance of a strong banking system.

Historically, when financial reform is stymied at the federal level, the states turn their attention to reform. For instance, NOW accounts, home state credit card advantage, and many other changes were initiated by populist state legislators. While the Fed and the OCC are changing the financial system through piecemeal regulatory permission of new banking activities, these changes are both insufficient and fragmented. The opportunity exists for states to adopt initiatives that break down the old system and establish a new system. There are at least two ways that states may accomplish this reform: (1) offer either a new charter for a financial company that has privatized deposit insurance and can sell insured and uninsured products or a charter that facilitates debanking by enabling banks to shift deposits to money funds; (2) amend securities powers under state blue sky laws that enable the direct sale of small denomination asset-backed securities to consumers. These moves would create competition for the old banking structure and would enable banks to resume their traditional role in creating prosperity. In sum, banks and thrifts should turn to the states for the powers they need to do the job.